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Example for fiscal prudence

By Steve Hanke, Special to Gulf News
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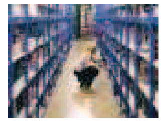
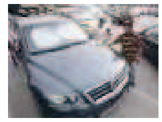
The New York Times columnist and Nobel laureate Paul Krugman, a devotee of the Manichean method, has pointed himself into a gloomy corner. For Krugman, no one has proposed a big enough economic stimuli programme to pull either the United States or Europe out of their current economic slumps. Dr Gloom is often joined in his advocacy of bigger stimuli packages by Dr. Doom - Nouriel Roubini, one of the first to detect the US housing bubble.

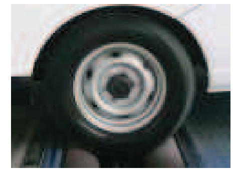
Both Krugman and Roubini are sceptical about rules, whether of the fixed or feedback variety. They also frown upon self-correcting adjustment mechanisms. For them, an ever-active state, discretionary fine-tuning and enlightened intervention are required to manipulate the economy in the national interest. In this, they follow in the footsteps of "cheap money" advocates such as John Law (1671-1729), Sir James Stewart (1721-1780) and John Maynard Keynes - who, with the publication of The General Theory of Employment, Interest, and Money in 1936, abandoned classicism, only to return to it shortly before his death in 1946.

Both Krugman and Roubini have fingered tiny Latvia as the canary in the international economy's "coal mine." They argue that Latvia is in the same boat Argentina was in late 2001. And as a result, Latvia will be forced to devalue its currency and default on its debt, as did Argentina in early 2002. Then, the argument goes, neighbouring Estonia and Lithuania would be forced to follow suit and a damaging wave would hit Central and Eastern Europe. This would be followed by yet more international gloom and doom.

Just what, if anything, does Latvia have in common with Argentina (2001)? On the surface, it appears that Latvia is employing the same type of exchange-rate system as did Argentina. Latvia's currency trades in a narrow band of plus or minus one per cent around a peg of 0.7028 lats per euro. In 2001, the Argentine peso was linked to the greenback at a one to one rate. But







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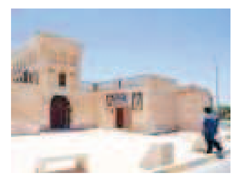

A stop-off at Delma Island

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those currency pegs are where the economic similarities between Latvia and Argentina stop.

For example, Latvia and its Baltic neighbours are models of fiscal prudence. This was not the case at the turn of the 21st century in Argentina.

In the monetary sphere, there is a straightforward way to determine the degree to which a monetary authority with a fixed exchange-rate regime respects the rules of orthodoxy. The most rule-bound system is a currency board. Just what is a currency board? It is a monetary authority that issues notes and coins convertible on demand into a foreign anchor currency at a fixed rate of exchange. As reserves it holds low-risk, interest-bearing bonds denominated in the anchor currency and typically some gold. The reserve levels are set by law and are equal to 100 per cent, or slightly more, of its monetary liabilities (notes, coins, and if permitted, deposits).

By design, a currency board has no discretionary monetary powers and cannot engage in the fiduciary issue of money. Its operations are passive and automatic. The sole function of a currency board is to exchange the domestic currency it issues for an anchor currency at a fixed rate. Consequently, the quantity of domestic currency in circulation is determined solely by market forces, namely the demand for domestic currency.

For a currency board, net foreign reserves (foreign assets minus foreign liabilities) should be close to 100 per cent of the monetary base (also called reserve money). Moreover, "reserve pass-through" (the change in the monetary base divided by the change in net foreign reserves over the period in question) should also be close to 100 per cent.

During the three years before the peso's demise, Argentina's convertibility system was not operating like a rule-bound currency board system (see accompanying chart). Indeed, its reserve pass-through was not even close to 100 per cent, and after mid-2001, its net foreign reserves, as a percentage of its monetary base, fell well below 100 per cent. By comparison, Latvia's monetary system - even though not legally a currency board system - is operating as

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though it were one. In consequence, Latvia could convert its entire monetary base into euros at the current exchange rate. The same can be said of Estonia and Lithuania - two countries that officially adopted currency board systems in 1992 and 1994, respectively. The data speaks clearly. Latvia and its Baltic neighbours are not repeats of Argentina.

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Sources: International Monetary Fund's International Financial Statistics (June 2009) and author's calculations